THE DAVIS FINANCIAL GROUP LLC

MassMutual

Market Update
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Courtesy of The Davis Financial Group

Let's try something different. Please read the following two paragraphs:

1) *President Trump's second term has been marked by an unprecedented surge in executive orders, a clear overreach of presidential power. With over 80 executive orders signed within the first few weeks of his second term, Trump has bypassed the legislative process and undermined the checks and balances that are fundamental to our democracy. This alarming trend starkly contrasts with previous administrations, where executive orders were used more sparingly and responsibly. For instance, President Obama averaged 35 executive orders per year during his two terms, while President George W. Bush averaged 36. Trump's actions have not only disregarded the will of the people but also have set a dangerous precedent for future presidents.*

And, next, paragraph two:

2) *President Trump's decisive use of executive orders in his second term demonstrates his commitment to fulfilling his campaign promises and addressing urgent national issues. By signing over 80 executive orders within the first few weeks, Trump has taken bold steps to protect American interests and ensure the efficient functioning of the federal government. This proactive approach stands in stark contrast to previous administrations, which often hesitated to use executive orders to their full potential. For example, President Franklin D. Roosevelt issued over 3,700 executive orders during his time in office, while President Jimmy Carter averaged 80 executive orders per year. Trump's leadership has brought about much-needed reforms and has set a new standard for presidential action.*

Now, if you're like most Americans, you will likely have despised one of those paragraphs and really supported the other. One likely aligns with what you believe, while the other likely does not. But can I ask…why? They are both factual and based on the same information, with slightly different references.

The (obvious) difference is the former is editorialized to lean left, and the latter is editorialized to lean right. But the facts are completely the same. Now imagine waking every morning to read only information that is similar to paragraph No. 1 (or No. 2, depending), and repeat that over and over for days, weeks, and months. As you might imagine, even without altering facts, it is quite possible we, shall we say, might have a slight tendency to, possibly, develop a bias or two?

And yet, we are tasked with fundamentally understanding what is truly happening in the world and, with any luck, reading enough of the tea leaves to help us make high quality decisions. So, what are we to do?

Therefore, while I rarely possess certainty[1], my only approach is to explore data and perspectives that have not been editorialized, so we can perhaps form our own (hopefully unbiased) opinions and use them to make better decisions.

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[1] As much as possible, we should channel Socrates, who famously stated in Plato's dialogue "Apology," "I am wiser than this man; neither of us probably knows anything worthwhile, but he thinks he knows something when he does not, whereas when I do not know, neither do I think I know; so I am likely to be wiser to this small extent, that I do not think I know what I do not know."

With that said, for this update, we will try to unpack the complicated (and rapidly changing) topic of tariffs.

Let us begin…

Who's on First? What is on Second?

For a moment, forget everything you know about tariffs.

Imagine you are a country with a new industry (let's say you want to begin producing cars), and you want to protect that industry. You believe this industry is going to be very important to your country, but you also know that your neighboring countries are much better at producing cars right now. So, you have three main choices:

a) You could let the market dictate the outcomes.
b) You could limit the number of cars that come into your country.
c) You could add a slight tax for the cars that come into your country.

That's it, ladies and gentlemen, you now understand all fundamentals of foreign trade: (a) is known as free trade; (b) is known as quotas; and (c) is known as tariffs—fancy names for some fairly basic objectives.

Tariffs aren't inherently "bad" or "good." They're just a tool. They simply change the incentives of the various trade partners, producers, and consumers.

So, my dear reader will quickly ask, "why do we care, and why are markets in the midst of a small tantrum?" Well, let us continue with this example for a moment and add some numbers…

Let's imagine there are two countries: Country 1 and Country 2.

Country 1 (for example, Germany) manufactures cars and sells them to Country 2 (for example, the United States). Each car costs $20,000 when imported into Country 2. And the car sells for $25,000.

Unfortunately, Country 2 doesn't like this arrangement and decides to impose a 25% tariff on cars imported from Country 1. This means an additional $5,000 is added to the price for the importing company in Country 2.

So, let's recap. Before the tariff on cars, the importing company in Country 2 paid $20,000 per car. Now, after the tariff, the importing company must pay $25,000 per car and decide how much to charge consumers.

What's hopefully clear with this simple example is that tariffs aren't good or bad, they are simply a tool. And to be clear, that tool can have important implications…

The importing company can now either a) absorb the cost (which reduces its profit), or b) pass the cost onto consumers in Country 2 through higher prices.

While different industries treat this in a variety of ways, *most* of the time the costs are passed onto the consumer.

Clear so far?

Tariffs, Tantrums, and Trade Turmoil

With the mastery of tariffs knowledge you now possess, here's the play by play:

Jan. 14: President-elect Trump announces plans to create the External Revenue Service to manage tariffs and duties from foreign sources. He plans to establish this agency on Jan. 20, upon taking office for his second term.

Jan. 26: The U.S. avoids a trade war with Colombia after the country agrees to accept military aircraft carrying deported migrants. Trump had previously threatened tariffs and sanctions due to Colombia's initial refusal.

Feb. 1: Trump declares a national emergency over illegal immigration and drug trafficking, including fentanyl. He imposes:
- 25% tariffs on imports from Canada and Mexico
- 10% tariffs on imports from China
- 10% tariffs on Canadian energy resources

Feb. 3: Trump delays the newly announced 25% tariffs on Canada and Mexico for one month after both countries agree to enhance border security.

Feb. 7: Trump postpones tariffs on low-cost (de minimis) packages from China until the Commerce Department ensures systems are in place to process packages and collect revenue.

Feb. 10: Trump says he will postpone a 25% tariff on steel and aluminum imports.

March 4: The Trump administration enacts previously delayed tariffs on Canada and Mexico, imposing a 25% levy on all imports from both nations. The president also adds an additional 10% tariff on all imports from China.

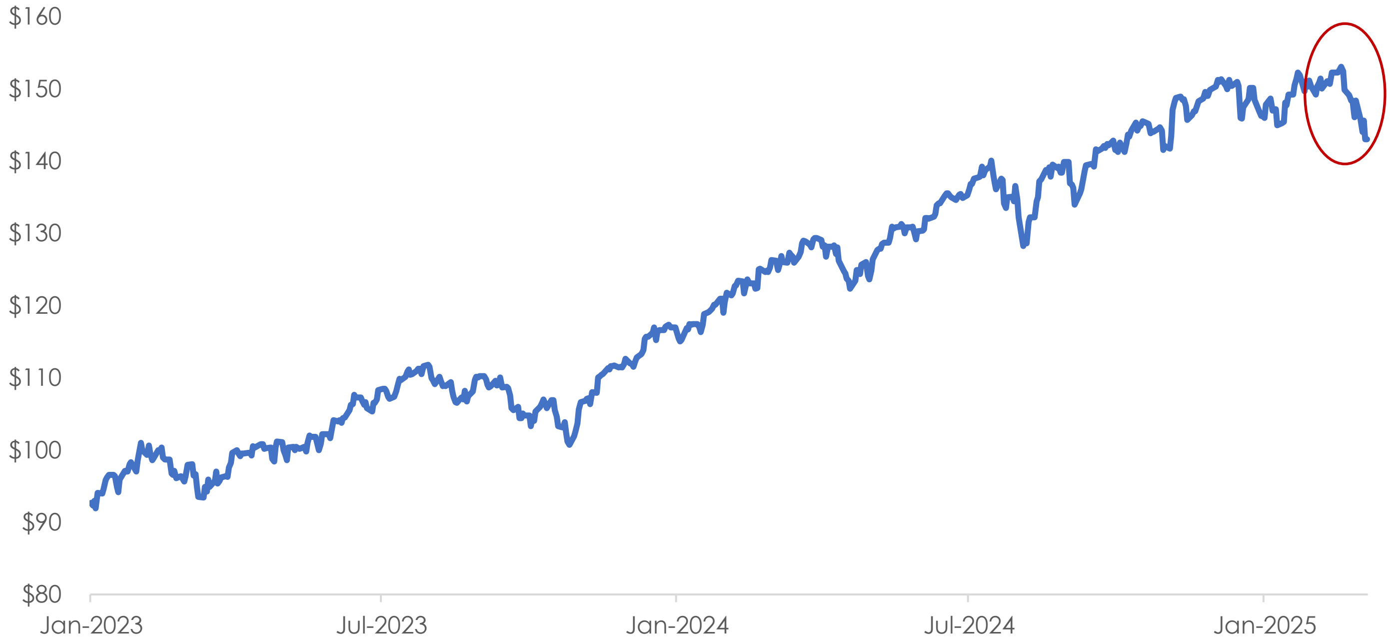
March 6: Trump pauses many tariffs on Canada and Mexico for one month, but only goods covered under the U.S.-Mexico-Canada Agreement (USMCA) are exempted from tariffs.

March 12 (expected): The Trump administration plans to impose a 25% tariff on all steel imports and raise the original 10% tariffs on aluminum imports to match the 25% duty on steel.

Confused yet? Well, yes, so are we, and candidly so are markets. Which brings us to Chart 1:

Chart 1: Cumulative Standard & Poor's 500 Returns[2]

[2] Source: Bloomberg, WMIT, through Aug. 20, 2024



While precise attribution is always difficult, the market clearly has not liked the uncertainty around tariffs (see red oval above). Each time a new tariff is announced, the market sells off, and each time a tariff has been put on hold, cancelled, or reduced, the market has moved higher.

Which makes sense. Tariffs, as we have seen with our simple example, generally raise costs. Costs going higher are, all things being equal, a) bad for growth, and b) bad for our continued quest to control inflation.

Does that mean this latest round of announcements will send the U.S. economy into a tailspin? No, I don't believe so, but we can confidently state that markets dislike uncertainty, and uncertainty is rising. Will our trade partners retaliate? Is this simply a negotiating tactic? No one truly knows…but given how chaotic the announcements have been, markets have become…understandably nervous.

Duty Today, Gone Tomorrow

With that out of the way, let us now turn to a little perspective to bring us home.

The first point is that as long as there has been trade, there have been tariffs. And we've always survived.

Some of the more notable examples:

- The Tariff Act of 1789 was one of the first major acts of Congress. It used tariffs as the primary source of federal revenue and protection for emerging American industries.

- The Tariff of Abominations (1828) imposed high duties on imports. While it benefited Northern industries, it negatively impacted Southern economies.

- The Morrill Tariff (1861), passed just before the Civil War, increased rates to protect Northern manufacturers and fund the Union war effort. There are some fascinating stories from this…in case my dear reader is so inclined.

- Smoot-Hawley Tariff (1930) was intended to protect American farmers and industries during the Great Depression.

There were also the Dingley Tariffs, the Underwood Tariffs, and the infamous McKinley Tariffs. While many of these made more sense when the U.S. was younger and had brand-new industries to protect, policymakers have continued to rely on them throughout the years.

And with that walk down memory lane out of the way, let us therefore summarize what we have learned:

1) Tariffs are not inherently bad or good; they are just a tool.
2) Tariffs at the margin, raise costs and will generally slow growth.
3) Tariffs have been used throughout U.S. history.
4) Markets are particularly uneasy right now about the high level of trade uncertainty.

And yet…

Capital markets, as they exist, are reflections of capitalism and the principles therein. And those principles remain in effect. Over the short term, the chaos we humans create causes markets to move higher and lower and do so in a wildly confusing and impossible-to-predict manner but, in the long-run, those principles drive investment returns. Savers are incentivized to provide their capital to productive companies for productive purposes and, in exchange, those savers receive a return on (and of) their capital.

In the short term, ladies and gentlemen, expect bumpiness. The changes being discussed are certainly unorthodox and, while we are watching closely, how this all nets out in the near term is impossible to predict.

We remain confident that capital markets, over reasonable time periods, will continue to generate returns above inflation. This is the foundation of wealth creation, and tariffs won't alter these fundamental principles.

We remain at your service and watching closely.

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